

Executive Summary:

At the April 3, 2002 meeting, the FASB continued its discussions regarding the proposed Interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, and FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, (the Interpretation), that would address issues related to identifying and accounting for special purpose entities (SPEs). A summary of tentative decisions through March 14, 2002 and additional background about the project is included in the March 21, 2002 edition of Accounting & Auditing News.

The more significant discussions and tentative conclusions reached at the April 3 meeting were as follows:

1. An SPE or a group of assets and liabilities that is included (i.e., consolidated) in the financial statements of a substantive operating entity should not be subject to the scope of the proposed Interpretation;
2. Additional guidance for determining the primary beneficiary for an SPE was needed. The application of proposed new guidance to seven different examples was discussed. In one particular example involving a Statement 140 qualifying SPE that issues beneficial interests to a multi-seller commercial paper conduit entity, the FASB was concerned about conflicts between its previous tentative decision regarding the consolidation of multi-seller conduits by the primary beneficiary (i.e., the transferor) and the guidance in Statement 140. As a result, the FASB discussed the potential of amending Statement 140 to resolve this conflict;
3. The 10% minimum amount that could represent substantive equity at risk should not be characterized as a "bright line", but rather as a presumed minimum threshold that could only be overcome in very limited situations; and
4. Additional transition time may be needed for certain SPEs.

The FASB is expecting to provide a draft Interpretation to the members of the Emerging Issues Task Force within the next several weeks for a "fatal flaw" review and is aiming to release an Exposure Draft for public comment by the end of April at the very earliest. The Interpretation would be exposed for comment for a minimum 30-day comment period. Additional details follow in "Further Discussion."

The FASB tentatively concluded that an SPE or a group of assets and liabilities that is included (i.e., consolidated) in the financial statements of a substantive operating entity should not be subject to the scope of the proposed Interpretation. The FASB indicated that in instances where substantive operating companies create shell corporations or special purpose corporations to achieve legal isolation or other objectives, with the full intent of consolidating the special purpose corporation in their financial statements, that the Interpretation should not be applied because the Interpretation is not trying to change

the accounting for these types of SPEs. As an example, substantive leasing companies that create separate, stand-alone subsidiaries (that are consolidated by the substantive leasing company) to hold specific assets and lease such assets to lessees, would appear to be scoped out of the Interpretation. In connection with reaching this tentative decision, the FASB agreed that the Interpretation would provide characteristics of substantive operating entities.

The FASB tentatively agreed to add the following guidance to the Interpretation to assist in identifying and evaluating variable interests to determine the primary beneficiary of an SPE:

- 1) The evaluation of variability is based on reasonably possible outcomes and not on extreme outcomes.
- 2) Contracts to provide services to an SPE in return for market-based fees, including incentive fees, are not considered a variable interest. The ability to replace the service provider without cause is an indicator that the fees are market-based. Arrangements that provide that the incentive fee is the equivalent to "net income" are not market-based.
- 3) The impact on the potential primary beneficiary's financial reporting should be considered (i.e., does the existence of the SPE significantly change the accounting results for one of the parties in the structure—if so, that may be an indicator of the primary beneficiary).
- 4) If different types of variable interests exist, the interest that has exposure to losses before other variable interests is considered the interest with the most variability.
- 5) If more than one entity holds variable interests in an SPE, the entity that holds significantly more variable interests than the interests held by others, is the primary beneficiary.

It is not clear whether the FASB intends that the presence of any of these indicators would be conclusive or if judgment would be applied in evaluating them.

Illustrative Examples

The FASB discussed the following examples in applying the proposed guidance for determining the primary beneficiary of an SPE that is subject to the scope of the Interpretation. The tentative alternatives chosen by the FASB for each example are shown in bold:

Example 1 — Arrangements with Multiple Participants to Buy Financial Assets (without a qualifying SPE [QSPE]) with Proceeds from Issuing Commercial Paper (i.e., a multi-

seller commercial paper conduit). Each transferor has the same risks and rewards as if it were in a single-entity SPE.

(a) Alternative A — Separate the Conduit into Silo SPEs for each transferor, and the transferor is the primary beneficiary for its Silo SPE because of the credit enhancements provided by the transferor.

(b) Alternative B — Do not separate the Conduit into Silo SPEs, and the Conduit's administrator is the primary beneficiary because the administrator receives the net spread earned by the Conduit.

(c) Alternative C — There is no primary beneficiary.

This tentative conclusion is consistent with previous conclusions that a transferor to a multi-seller SPE should consolidate its transferred assets and the related debt held by the multi-seller SPE.

Example 2 — Arrangements with Multiple Participants to Buy Financial Assets from QSPEs with Proceeds From Issuing Commercial Paper (i.e., a multi-seller commercial paper conduit that purchases beneficial interests from a QSPE)

(a) Alternative A — Separate the Conduit into Silo SPEs for each transferor, and the transferor is the primary beneficiary because of the credit enhancements provided by the transferor. The scope exception for transferors to QSPEs applies only if the QSPEs issue beneficial interests to substantive entities.

(b) Alternative B — Do not separate the Conduit into Silo SPEs, and the Conduit's administrator is the primary beneficiary because the administrator receives the net spread earned by the Conduit. The provision in Statement No. 140 that the transferor to a QSPE does not consolidate the QSPE prevents the transferor from being a possible primary beneficiary. The credit enhancements are between the transferor and the QSPE; not between the transferor and the Conduit.

(c) Alternative C — There is no primary beneficiary.

This particular example received the most discussion because in this scenario, the transferor of the financial assets to the QSPE is precluded from consolidating the QSPE under Statement 140 and the FASB perceived that Statement 140 would preclude the transferor from looking through the QSPE. However, the FASB was significantly troubled by the fact that the answers in Example 1 and Example 2 would be different simply because Example 2 was structured using a QSPE. As a result, the FASB tentatively agreed that Alternative B would be the best alternative short of amending Statement 140. However, the FASB ultimately decided to explore this issue further and to determine if Statement 140 could, or should, be amended either before or in conjunction with the issuance of the Interpretation to require that the third party

beneficial interest in the financial assets of the QSPE be held by an entity for which the transferor is not deemed to be the primary beneficiary under the proposed Interpretation.

Example 3 — Commercial Paper Loan Conduit

(a) Alternative A — The Conduit's administrator is the primary beneficiary because the administrator receives the net spread earned by the Conduit.

(b) Alternative B — There is no primary beneficiary.

Example 4 — Collateralized Debt Obligation Arrangement

(a) Alternative A — If an entity holds a significant portion of the variable interests (the preferred shares have the most variability and the non investment grade notes have the remaining variability) and that amount is significantly more than the interests held by others, that entity is the primary beneficiary. If no entity meets that condition, there is no primary beneficiary. (Emphasis added)

(b) Alternative B — The collateral manager that receives a market-based fee and that holds a significant amount of the variable interests is the primary beneficiary regardless of the ownership of the other variable interests.

(c) Alternative C — The entity that provides the most services to the CDO (collateral manager, placement agent, etc.) and holds a significant amount of the variable interests is the primary beneficiary even if the fees for the services are market-based.

(d) Alternative D — There is no primary beneficiary.

Example 5 — An 80-20 Joint Venture Arrangement with Predetermined Activities

(a) Alternative A — The entity that holds an 80% economic interest (but technically has a 50% voting interest) is the primary beneficiary because of its level of economic interest.

(b) Alternative B — There is no primary beneficiary because of the 50/50 split in voting interests even though the activities of the Joint Venture are predetermined.

The FASB emphasized that due to the fact that this arrangement has predetermined activities that significantly dilute the notion of "voting control", the determination of the primary beneficiary would focus on risk and rewards and the level of economic interest held by each party. Even if there were four parties to the arrangement that shared voting control equally, but one of the parties held more economic interest than the other three parties, the party with the most economic interest would be deemed to be the primary beneficiary and would consolidate the entity under the Interpretation.

Example 6 — A Non-Substantive Long-Term Lessor SPE in a Non-Synthetic Operating Lease with the Lessee

(a) Alternative A — The lender to the SPE is the primary beneficiary because it bears the credit risk with respect to the lessee and collateral value risk with respect to the leased property.

(b) Alternative B — The lessee is the primary beneficiary because it bears the risk of the change in the value of the leased property for the majority of the property's economic life and value.

The FASB emphasized that if there were a third party residual or debt guarantor in this arrangement that an evaluation would have to be made to determine if that guarantor would be deemed to be the primary beneficiary.

Example 7 — A Non-Substantive Long-Term Lessor SPE in a Synthetic Operating Lease with the Lessee

(a) Alternative A — The lender to the SPE is the primary beneficiary because it bears credit risk with respect to the lessee.

(b) Alternative B — The lessee is the primary beneficiary because it bears the risk of the change in value of the leased property for all reasonably possible outcomes and has the ability to obtain the benefit of an increase in value of the leased property.

All of these examples seem very facts and circumstances specific. The FASB did not describe in detail the salient facts in any of these examples, but provided a high level summary and preliminary conclusion for each example as shown above.

The FASB reached a tentative conclusion that the Interpretation should not express the minimum amount of substantive equity at risk as a "bright-line" (i.e., 10%), but rather characterize the minimum amount of substantive equity at risk as the amount of equity that will provide the SPE the ability to fund or finance its operations without assistance from or reliance on the primary beneficiary with the presumption that this amount must be at least 10% of the SPE's total capital. It would be expected that this presumption could only be overcome in very limited situations.

The FASB retained its tentative conclusion that there will be no grandfathering of preexisting SPEs under the Interpretation, but indicated that it is considering extending the transition period for certain SPEs (e.g., commercial paper conduit facilities) that exist prior to the issuance of the Interpretation.